INDEX TO APPENDIX.

Appendix A—

PAGE

Opinion of the Court of Appeals of Kentucky, 436 S. W. 2d 522 15–19

Opinion of the Jefferson Circuit Court, Chancery Branch, Second Division 20–26

Order of the Kentucky Board of Tax Appeals, No. K65-R-5 27–30

Appendix B—

Mandate of the Kentucky Court of Appeals 31

APPENDIX "A"

COURT OF APPEALS OF KENTUCKY

RENDERED: OCTOBER 15, 1968

DEPARTMENT OF REVENUE, COMMONWEALTH OF KENTUCKY, - - - - - - - - *Appellant,*

v.

SPALDING LAUNDRY AND DRY CLEANING COMPANY, - - - - - - - - - - *Appellee.*

Appeal from Jefferson Circuit Court, Chancery Branch, Second Division, Hon. Marvin J. Sternberg, Judge.

OPINION OF THE COURT BY COMMISSIONER CLAY—REVERSING.

This is an appeal from a judgment setting aside an order of the Kentucky Board of Tax Appeals which confirmed a sales tax assessment against appellee. The trial court found that KRS 139.170, which defines exempted "machinery", in failing to encompass appellee's property was arbitrary and unreasonable, and consequently violative of sections 3 and 171 of the Kentucky Constitution and the Fourteenth Amendment to the United States Constitution. The statute in question was declared void.

Appellee is engaged in the laundry and dry cleaning business. When expanding its plant in 1965 it purchased some new machinery. It claimed this machinery exempt from the sales tax under KRS 139.480(8), which exempts "Machinery for new and expanded industry". However, KRS 139.170 defines such machinery as:

> "* * * that machinery used directly in the manufacturing process, which is incorporated for the first time into plant facilities established in this state, and which does not replace machinery in such plants."

Appellee concedes that it is not in a manufacturing industry and therefore its new machinery is not exempt under the definition last above quoted. See Muir v. Samuels, 110 Ky. 605, 62 SW 481. Its contention, upheld by the circuit court, is that the statute, in restricting exempt machinery to that used in *manufacturing*, is arbitrarily and unreasonably discriminatory.[1]

There is no controversy about the applicable legal principles. In the field of taxation (as in other areas) the legislature may make classifications, and the constitutional limitations prohibit only such classifications as are arbitrary and unreasonable in having no fair and substantial relation to the permissible governmental purpose of the legislation. See Burge v. Marcus, Ky., 394 SW 2d 908; Louisville Gas Co. v. Coleman, 277 U.S. 32. Our question is whether the exemption of machinery used in manufacturing is arbitrary and unreasonable because it does not equally exempt similar machinery used in a service industry or plant.

It is common knowledge that in recent years states have strenuously competed for new and expanded industrial development to improve the overall economy of the sovereignty. The promotion of such development, by providing tax benefits, is now a fixed policy of this Commonwealth. In 1955 the people of this state, by amendment to section 170 of the Kentucky Constitution, empowered the General Assembly to authorize cities or towns to exempt "manufac-

[1]Appellee can only succeed if the restrictive definition statute, KRS 139.70, is knocked out and KRS 139.480(8) (which it modifies) does not fall with it, thereby creating an exempt category of all "machinery for new and expanded industry."

turing establishments" from municipal taxation (for a period not exceeding five years) "as an inducement to their location". By KRS 91.260 and 92.300 the legislature has authorized cities to exempt "manufacturing establishments" from city taxation. KRS 132.200(4) exempts from county, city, school, or other taxing district taxes, machinery "of individuals or corporations actually engaged in manufacturing, * * *".

It is evident therefore that in the minds of the people and the legislature a legitimate public purpose is served by encouraging the location and expansion of manufacturing industries in this state. That such tax exemption statutes are valid is not questioned. See 51 Am. Jur., Taxation, section 591 (page 576); Todd County v. Bond Bros., 300 Ky. 224, 188 SW 2d 325. As pointed out in that case, the objective was to increase the resources of the state and its taxable property "through the establishment of new industries".

It is the contention of appellee that since the purpose of such statutes is the promotion of the general welfare by improving the economy of the state, it is arbitrary and unreasonable to discriminate between different kinds of industrial machinery. However, it is peculiarly a matter of legislative selection, in balancing the public benefits against the tax loss, to determine what type of industry will best promote the general welfare. Considering the public purpose involved, surely the legislature could distinguish between large plants and small plants.

It is entirely reasonable for such a body to conclude that the development of manufacturing plants would have a greater beneficial impact on the state economy than the development of other industries. The reasonable basis for putting a manufacturing plant in a class by itself, for the purpose of inducing its location in Kentucky by bestowing tax benefits, is pointed out in City of Lexington v. Lexing-

ton Leader Co., 193 Ky. 107, 235 SW 31. It was there said that the location of a newspaper was a matter generally influenced by local circumstances unrelated to tax benefits. We may also observe that a newspaper might well offer less in the way of employment and the utilization of natural resources than a manufacturing plant.

Of course it can be said that any industry improves the economy of the state, and carried to its logical conclusion appellee's argument would invalidate any discriminations based on the *use* of the property involved. Yet it will be noted that the exempt status of the eight different classes of property provided for in KRS 139.480 is tied to the use of such property. It is common knowledge that the tax benefit provisions of our Constitution and statutes here under consideration were principally designed to induce the location in Kentucky of outside interests, and particularly the most successful one available. It is not unreasonable to conclude that the manufacturing industry offered the best field for promotion. Service and other industries would normally offer a lesser potential from the standpoint of capitalization, employment, stability and expansion. Manufacturing machinery produces goods which ordinarily would be subject to the sales tax, whereas service industries do not produce a taxable product. At least these are valid considerations the legislature could take into account.

This is a policy matter which, as we have said, is peculiarly one for legislative determination. The wisdom of the policy is a matter not before us. There are sound reasons which justify placing in the tax exempt category only that machinery for new and expanded industry which is used in the manufacturing process. We do not find KRS 139.170 arbitrary and unreasonable.

It is unnecessary to pass upon other questions raised on this appeal.

The judgment is reversed, with directions to enter a judgment for the Commonwealth affirming the order of the Kentucky Board of Tax Appeals.

All concur except Osborne, J., not sitting.

Attorneys for Appellant:

WILLIAM S. RILEY,
Assistant Attorney General,
Frankfort, Kentucky,

PAUL SHAPIRO,
Legal Staff,
Department of Revenue,
Capitol Annex Building,
Frankfort, Ky. 40601.

Attorneys for Appellee:

CARL L. WEDEKIND, JR.,
STITES, PEABODY & HELM,
1212 Kentucky Home Life Building,
Louisville, Kentucky 4020.

JEFFERSON CIRCUIT COURT

CHANCERY BRANCH, SECOND DIVISION

No. C95763

SPALDING LAUNDRY & DRY CLEANING COMPANY, - *Appellant,*

v.

DEPARTMENT OF REVENUE OF COMMONWEALTH OF KENTUCKY, - - - - - - *Appellee.*

OPINION.

This is an appeal from a final order of the Kentucky Board of Tax Appeals (KRS 131.370[1]).

Appellant, hereafter referred to as Spalding, operates a laundry and dry-cleaning business in Louisville, Jefferson County, Kentucky. During the years 1960 through 1964, it purchased various pieces of machinery and equipment to facilitate the handling of the increase in its business. The new machinery was necessary due to a great increase in volume of business, for the addition of new special services and for equipping additional outlets at new locations.

The only question before the Court is whether KRS 139.170 makes an unreasonable classification between "machinery used in manufacturing process" and "machinery used in laundry and dry-cleaning processes."

It is provided by KRS 139.480(8):

> "Any other provision of this chapter to the contrary notwithstanding, the terms 'sale at retail,' 'retail sale,' 'use,' 'storage,' and 'consumption,' as used in this

chapter do not include the sale, use, storage, or other consumption of:

"(8) Machinery for new and expanded industry."

"Machinery for new and expanded industry" is defined by KRS 139.170 as:

"'Machinery for new and expanded industry' shall mean that machinery used directly in the manufacturing process, which is incorporated for the first time into plant facilities established in this state, and which does not replace machinery in such plants."

Appellant is engaged in a "service industry" and not in a "manufacturing industry" (Muir v. Samuels, 110 Ky. 605, 62 S. W. 481; City of Lexington v. Lexington Leader Company, 193 Ky. 107, 235 S. W. 21). Appellant charges that, and the salient question before this Court is whether, the classification which creates a distinction between a "service industry" and a "manufacturing industry" is arbitrary and unreasonable, thereby in violation of Sections 3 and 171 of the Kentucky Constitution and the Fourteenth Amendment to the Constitution of the United States.

Sections 3 and 171 of the Kentucky Constitution authorize the Legislature to place property in different classifications and to exempt certain properties from taxation so long as the classification is not arbitrary or unreasonable.

The Fourteenth Amendment to the Constitution of the United States guarantees that all persons within a legal classification are treated alike.

Appellant is not challenging a classification of *taxpayers* or property, but its challenge is directed at an attempted classification based on the *use* to which an article is put after its sale. In other words, the Court must determine whether the classification of machinery

used in the manufacturing process as against machinery to be used in non-manufacturing process are classifications reasonably related to a valid objective.

In the case of Marcum v. City of Louisville Municipal Housing Commission, Ky., 374 S. W. 2d 865, the Court of Appeals held that the tax imposed by Chapter 139 KRS is on the retailer and not on the consumer. In the course of the opinion the Court stated:

> "* * * The Kentucky statute merely permits the retailer to collect from the consumer. The fact that the burden may be passed on certainly does not convert the tax from one on the retailer to one on the consumer."

The classification, be it a classification based upon retail sales or a classification based on the use to which the property is put (the consumer), must rest on some difference having a fair and substantial relation to the object sought to be accomplished. If the classification does not have a fair and substantial relation to the object sought to be accomplished, then and in that event all persons in the classification are not treated alike and there is an arbitrary imposition of the tax.

This is borne out by the case of Hartman v. City of Louisville, 282 Ky. 487, 138 S. W. 2d 948, wherein the Court of Appeals stated:

> "That the legislature may classify objects of taxation is no longer open to doubt. The only restriction being that classification must rest on a reasonable basis."

With respect to classification based on manufacturing, we find in 51 Am. Jur., Taxation, § 591, that:

> "There is no doubt of the power of the legislature to exempt manufacturers and manufacturing enter-

prises from taxation as a matter of public or governmental policy when its powers in this respect are not limited by the state constitution and the primary purpose is not to aid and benefit private persons for private ends, but to benefit the public at large, by increasing in the end the resources of the state in its taxable property through the establishment of new industries."

In the case of Reeves v. Louisville Gas & Electric Company, 290 Ky. 25, 160 S. W. 2d 391, the Court of Appeals recognized that:

"* * * The underlying purpose of the constitutional amendment to Section 171 and the statute is, in part, to encourage manufacturing for its consequent public benefit. * * *"

Argument was made that the exemption of machinery from ad valorem taxes was invalid. Although there actually was no challenge based on classification of property, yet the classification was recognized and upheld.

In the case of Todd County v. Bond Bros., 300 Ky. 224, 188 S. W. 2d 325, the Court of Appeals held that certain products did not come within the definition of "manufactured products" as provided by Kentucky Statutes. No question was raised as to the classification between "manufactured products" and "products in the course of manufacture". In the course of the opinion, however, the Court stated:

"* * * No doubt exists as to the power of the Legislature to exempt manufacturers, manufacturing enterprises as a matter of policy primarily not to aid in the benefit of private persons for private ends, but for the benefit of the public at large by increasing resources of the state and its taxable property through the establishment of new industries. * * *"

In the case of City of Covington v. Dalheim, 126 Ky. 26, 102 S. W. 829, the Court of Appeals considered an ordinance purporting to levy a tax on the business of a grocer. The Court of Appeals, however, determined that in actuality the tax was not on the grocer but was on the vehicles used to deliver the groceries and was beyond the authority of the City to tax. In the course of the opinion, the Court of Appeals, speaking by Judge O'Rear, said:

> "It is competent for the city to select any of the enumerated classes as subjects for license taxes. But it is not competent for it to tax some members of a class set apart by the Legislature and not tax others of the same class. * * *"

In the case at bar, this Court determines that it was the intention to provide an exemption which would encourage new and expanded industry.

The case of United Shoe Machinery Corp. v. McCracken County, Ky., 265 S. W. 2d 929, cited by attorney for the respondent, merely affirms the proposition that machinery used in the course of manufacturing is a proper subject for special consideration as was held in the cases of Reeves v. Louisville Gas & Electric Company and Todd County v. Bond Bros., supra.

The purpose of the legislation was to stimulate industry that is presently operating in the Commonwealth of Kentucky and to encourage new industry to come into Kentucky. The economic growth of Kentucky and the prosperity of its citizens is no less sought, stimulated or desired from service industries than from manufacturing industries. They are both sought and needed. Service industries are more numerous and usually have less financial investment. The desirability in the Commonwealth of a service industry is no less than a manufacturing industry. As a matter of fact many of the smaller communities in this Commonwealth can, and as a matter

of fact, are benefited from service industries where they have no possibility of securing aid from a manufacturing industry. The economic help available for the Commonwealth of Kentucky as a whole, with special emphasis on the smaller communities, is stimulated by service industries. "Machinery for new and expanded industry" is just as necessary and important for service industries as to manufacturing industries.

This Court, as well as counsel for appellant, agrees with the statement of counsel for appellee which appears on page 3 of his brief filed with the Kentucky Board of Tax Appeals that:

> "* * * The purpose of the exemption for new and expanded industry was clearly intended to encourage the location of new industry in this state and the expansion of existing industry. * * *"

There is no contention made that the establishment of a new service industry or the expansion of an existing service industry is not as much for the benefit of the public at large, or is less related to the purpose for which the tax is imposed, than is the establishment of a manufacturing industry or the expansion of a manufacturing industry. There is no difference in the end to be accomplished.

The act under consideration was adopted by the regular 1960 session of our General Assembly. The challenged definition section (KRS 139.170) appears in the original act as Article I, Section 17. The exclusive section, which now appears as KRS 139.480(8), appears in the act as Article I, Section 47(h). The elimination of KRS 139.170 will not have the effect of cancelling out or eliminating KRS 139.480(8), but will give equal treatment to all taxpayers in the same classification.

The Court of Appeals of Kentucky, in the case of Burns v. Shepherd, 264 S. W. 2d 685, and in the case of City of Pineville v. Farrow, 273 S. W. 2d 56, held that if the in-

valid part of a statute is severable from the rest, the valid part may be sustained; but where provisions are so connected that it cannot be presumed that the Legislature would have passed one without the other, the whole statute falls. The definition provision is severable from the exclusion provision, and there is no doubt in this Court's mind that the Legislature would have adopted the exclusion irrespective of the definition. The exclusion (KRS 139.480[84]) affords all the relief offered by the defintion section (KRS 139.170) but will extend the exemptions to non-manufacturing industries.

It is the opinion of the Court, therefore, that the attempt by the Legislature to eliminate from the exclusion, by definition, service industry creates an unreasonable classification unrelated to the object sought to be accomplished by the act. The definition, therefore, would be in violation of Sections 3 and 171 of the Kentucky Constitution and the Fourteenth Amendment to the United States Constitution in that not only does the definition create an arbitrary and unreasonable classification, but also it denies to all people within the legal classification similiar treatment.

Counsel for the appellant will prepare an order in keeping with this Opinion and tender it to this Court for entry on Thursday, November 2, 1967, at 10:00 a.m., to which time this cause it now continued.

Marvin J. Sternberg,
October 24, 1967 *Judge*

cc: Mr. Carl L. Wedekind, Jr.
Attorney for Appellant
1212 Kentucky Home Life Building
Louisville, Kentucky 40202

Mr. Paul Shapiro
Attorney for Appellee
Department of Revenue
Frankfort, Kentucky 40601

APPENDIX "A"

KENTUCKY BOARD OF TAX APPEALS

No. K-65-R-5

SPALDING LAUNDRY AND DRY CLEANING COMPANY, *Appellant*

v.

DEPARTMENT OF REVENUE, COMMONWEALTH OF KENTUCKY, *Appellee*

ORDER No. K-222

The issue presented on this appeal is whether laundry and dry cleaning equipment are "machinery for new and expanded industry" within the meaning of KRS 139.480(8) and is thus exempt from sales and use taxation.

Appellant, Spalding Laundry and Dry Cleaning Company, operates a laundry and dry cleaning business. It purchased certain items of equipment for usage in its business. The Department of Revenue made an assessment of sale and use tax on the purchase of this equipment and confirmed the assessment by final action in letter form dated March 3, 1965. This appeal timely followed.

Appellant contends on this appeal that:

1. The items of equipment qualify as "machinery for new and expanded industry" and are therefore exempt from sales and use taxation under KRS 139.480(8) and KRS 139.470.

2. If the equipment does not qualify as exempt under the foregoing statutes, then KRS 139.470 is unconstitutional as making an unreasonable classification between machinery

used in the manufacturing process and in the non-manufacturing process.

The statutes in issue here are KRS 139.480 and KRS 139.470. KRS 139.480 exempts from sales and use taxation:

"(8) Machinery for new and expanded industry."

As definitive of this exemption, KRS 139.470 states:

> "'Machinery for new and expanded industry' shall mean that machinery used directly in the manufacturing process, which is incorporated for the first time into plant facilities established in this state, and which does not replace machinery in such plants."

We do not think that a laundry and dry cleaning business comprises a "manufacturing process" as that term is used in KRS 139.470. The usual and customary meaning of manufacturing does not come to mind when a shirt is laundered or a suit is cleaned. A manufacturer sells a product but a laundry and dry cleaning business sells a service. This particular question was fully considered in American Tobacco Co. v. City of Bowling Green, et al., 265 S. W. 570. It was therein said:

> "(1, 2) It is somewhat difficult to formulate a satisfactory definition as to what constitutes manufacturing, from the decisions of the courts, or to say when it begins. In Words and Phrases, vol. 5, p. 4348, it is said:
>
> > 'The primary meaning of the word "manufacturing" is something made by hand as distinguished from a natural growth; but, as machinery has largely supplanted this primitive method, the word is now ordinarily used to denote an article upon the material of which labor has been expended to make the finished product. Ordinarily, the article so manufactured takes a different form, or at least subserves a different purpose, from the original materials, and

usually it is given a different name. Raw materials may be, and often are, subjected to successive processes of manufacture, each one of which is complete in itself, but several of which may be required to make the final product. Thus logs are first manufactured into boards, planks, joists, scantlings, etc., and then by entirely different processes are finished into boxes, furniture, doors, windows, sashes, trimmings, and a thousand and one articles manufactured wholly or in part of wood. The steel spring of a watch is made ultimately from iron ore, but by a large number of processes or transformations, each successive step in which is a distinct process of manufacture, and in which the article so manufactured receives a different name.' Citing Tidewater Oil Co. v. United States, 171 U. S. 210, 18 Sup. Ct. 837, 43 L. Ed. 139, and State v. American Sugar Refining Co., 51 La. Ann. 562, 25 South. 447.

"The generic meaning of the term 'manufacture' is 'made by hand'; but in the development of business manufacturing has come largely to mean a process of making things by machinery. But there is no hard and fast rule which can be applied generally; each case must be decided under its own facts, and with a view of carrying out the intention of the Legislature by giving a reasonable interpretation of the statute involved. Thus in Re Troy Steam Laundering Co. (D.C.), 132 Fed. 266, where the laundering company was engaged chiefly in taking collars and cuffs from the companies that manufactured them, and putting the final polish on the collars and cuffs before they were sold as a part of the completed garment, it was held that the laundering company was engaged in manufacturing. But where a steam laundering company receives the soiled collars and cuffs from a customer for the purpose of washing

and ironing them, can it be said that it is then engaged in manufacturing? Clearly not, although the two processes were substantially identical. Muir v. Samuels, 110 Ky. 605, 62 S. W. 481, 23 Ky. Law Rep. 14."

KRS 139.170, in creating an exemption for machinery used in the manufacturing process, has not established an unreasonable classification. A similar issue involving another tax exemption statute was involved in the case of Todd County v. Bond Brothers, 188 S. W. 2d 325, and it was therein said:

"No doubt exists as to the power of the legislature to exempt manufacturers, manufacturing enterprises as a matter of policy primarily not to aid in the benefit of private persons for private ends, buf for the benefit of the public at large by increasing the resources of the state and its taxable property through the establishment of new ndustries."

It Is Therefore Ordered by the Kentucky Board of Tax Appeals that the final action dated March 3, 1965, by the Department of Revenue against Spalding Laundry and Dry Cleaning Company be and the same is hereby affirmed.

This 29 day of October, 1965.

Kentucky Board of Tax Appeals

(s) Jack T. Page,
Chairman

Attested:

By: (s) Ellis A. Merrifield,
Clerk

APPENDIX "B"

MANDATE.

THE COMMONWEALTH OF KENTUCKY,
The Court of Appeals
Fall Term—October 25, 1968

DEPARTMENT OF REVENUE, COMMONWEALTH OF KENTUCKY

v.

SPALDING LAUNDRY & DRY CLEANING CO.

CR 95763

Appeal from a judgment of the Chancery Branch, 2nd Division, Jefferson Circuit Court.

The Court being sufficiently advised, it seems to them the judgment herein is erroneous.

It is therefore considered that the judgment is reversed, with directions to enter a judgment for the Commonwealth affirming the order of the Kentucky Board of Tax Appeals; which is ordered to be certified to said Court.

It is further considered that the appellant recover of the appellee its cost herein expended.

Judge Osborne not sitting.

A copy—attest:

Dick Vermillion, C. C. A.
By (s) John C. Scott, D. C.

Issued February 21, 1969.